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How Brazilian Private Equity is Navigating the Downturn

From the Privcap webinar “Private Equity in Brazil: Optimism Amid the Turmoil”

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How Brazilian Private Equity is Navigating the Downturn

Experts from Advent International and Stratus Group discuss how the current downturn in Brazil relates to those of the past, which sectors are showing the most deal flow, and how the currency situation is impacting their portfolios.

The Panelists

Álvaro Gonçalves
Co-founder,
Stratus Group

Mario Malta
Managing Director,
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Privcap: What's it's like to be a private equity investor in Brazil right now? How does this downturn compare to those in the past?

Álvaro Gonçalves, Stratus Group: The private equity environment in a downturn is actually an opportunity for good investments. And we've been through two very specific situations that have some similarities to this one.

The years 2002 and '03 were the worst scenario, because many of the situations we had in front of us were unknown. There was a new government coming in that had never been in power before, and there was a shift in economic management.

In 2008 and '09, the crisis was less important to Brazil. We still had the commodity prices in the upper level. On the other hand, there was also the perception that the crisis was mostly generated outside of Brazil, and therefore, people didn't look at Brazil as rigorously as people are doing right now.

Mario Malta, Advent International: Like Alvaro said, when we compare the 2008 crisis with this one, the big difference is 2008 was a global crisis. Brazil was seen by some investors as a safer place to be, especially because the country had low leverage levels, and low exposure to derivatives compared to the developed countries. And it was actually posting a healthy growth rate back then.

Now, it's the opposite. The world is performing relatively well. The level of attention and concern of international investors to the Brazilian situation is much higher than it was before.

One common theme is regarding what we call the waves of pipeline. So, like we saw in 2002 and '08, when the capital markets are closed like they are now, the [deal] pipeline tends to fill up pretty fast. However, our experience shows that the first companies to appear on the radar are normally the ones that need money to survive. However, after a certain time, great companies start to enter the funnel—companies that are not desperate for money.

What deal flow are you seeing at the moment?

Malta: There are sectors that are suffering more, especially the ones that are entirely dependent on internal consumption—retail, for instance, and maybe real estate.

But there are sectors that are performing well, especially the ones that are more resilient, such as healthcare, essential services, education, or certain subsectors in the infrastructure world. One interesting case is our investment in a company called Cataratas do Iguaçu, which holds the concessions to operate in national parks in Brazil like the Iguazu Falls, Christ the Redeemer in Rio, and so on.

Due to the strong currency devaluation, it became extremely expensive for Brazilians to travel abroad. At the same time, it became very cheap for international tourists to visit Brazil. So this is one example of a company that is actually benefiting from one macro factor, which is the currency. But it's important to make it clear that many of the GPs here are not pursuing macro plays. They are actually looking for specific subsectors that may perform well despite the economic situation.

> "The private equity environment in a downturn is actually an opportunity for good investments."
>
> –Álvaro Gonçalves, Stratus Group

What tools should a good private equity GP have to help a portfolio company through a challenging macroeconomic environment?

Malta: In the case of Advent, I can mention two very important tools that we use. One is what we call the portfolio support group, which is a team of people that is entirely dedicated to value-creation initiatives at the portfolio companies. And the second tool is our network of operating partners.

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Gonçalves: In our case, we don't have a specific program for this except for the fact that we are spending much more time in the companies than ever before. It's very important to keep close to the CEO and the CFO, be conservative in assumptions, and follow the steps of the company's execution more closely.

> "The level of attention and concern of international investors to the Brazilian situation is much higher than it was before"
>
> –Mario Malta, Advent International

How much of an impact is the currency situation or debt having on your portfolio?

Malta: We are a dollar-based fund, so we need to deliver good results in dollar terms. Long-term hedging is extremely expensive or not available. What we are doing more and more is structuring the deals— using deferred payments and earn outs—as a way to mitigate the currency risk. So we had a deal in Brazil in which we paid less than 25 percent of the price up front. The remaining 75 percent is being paid over several years.

Gonçalves: There are ways to mitigate the risk. So spacing and pacing our capital calls, pacing the payments for the companies making capital injections in a sequence and not all cash up front, and mapping the business plan. And paying the share purchase installments in a way that the currency risk is mitigated is very important. But it's still very difficult to be effective on valuations up front, because it's difficult to have the same usual levels and certainty on the projects for the next couple of years. ■

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